Connecting the Dots

Episode 1: Mid-year investment perspectives with three CIOs
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Jim Leaviss, opening SOT: So, I think that one thing bond markets are worried about is that across the world, all politicians want to give stuff away, and not many of them want to pull back the reins on government borrowing too much.

Speaker 1: Connecting the Dots, an M&G Investments podcast. This episode is for investment professionals only.

Romil Patel: Hello and welcome to the debut episode of M&G investments' new podcast series, *Connecting the Dots*, where each month, experts from across our global network of investors will join us to bring you their views across equities, fixed income and private markets.

My name is Romil Patel, Global Managing Editor, and I'm delighted to be sat alongside Fabiana Fedeli, CIO for Equities, Sustainability and Multi-Asset; Jim Leaviss, CIO for Fixed Income; and Emmanuel Deblanc, our new Private Markets CIO. Welcome to you all.

All: Thank you.

Romil: Pleasure to have you here today. The midway point of the year is typically a good time to pause and take stock of what has and hasn't transpired across global financial markets – and what this means for investors. While some emerging markets have begun loosening monetary policy, all eyes are on rates in the US and the UK, where voters will be heading to the polls this year as well as the eurozone. So, Jim, where are we now and what's the outlook from here?

Jim: Well, the very good news is that it does look that inflation is finally transitory. It's on its way down across developed markets and that's going to give central banks the chance to cut interest rates later this year.

The bad news is that in certain areas – and particularly in the US – it's looking a bit stickier on the inflation outlook than perhaps people had hoped for. I think there are a few reasons for that. First of all, the US is still running very stimulative fiscal policy so it's got a huge budget deficit of around 6 or 7% of GDP, which is extraordinary at this time of an economic cycle with growth so strong in the US.

Secondly, the wealth effect. Everyone feels rich because their equities have gone up over the past year or so and that's leading to, animal spirits still being very present in the US. And finally, they've had a lot of immigration, both legal and illegal, that's raised the working age population and led to some fantastic growth numbers.

Bank of England is probably on hold until after the general election's out of the way, but they'll go next and I guess the outlier globally is Japan. They'll be hiking rates just as everyone's been cutting rates, because for the first time in decades, they've got a bit of growth, a bit of inflation and the first tiny signs of some animal spirits too.

Romil: Well Fabiana, equities are sitting at all-time highs and this must bode well. What's the outlook from here?

Fabiana: Well, with interest rates at peak, hopefully, and a growth backdrop that is still solid in the United States and actually slightly improving in other areas in the world, equities have a positive outlook, especially if you consider that there are some drivers of this positive fundamental growth, and some of them are around innovation. Of course, some of the markets have performed very well. So we need to make sure that we understand where valuations are actually already discounting all the good things that can come ahead and where perhaps there's still some value.

Romil: Indeed, and we'll come to selectivity shortly too. But before we do, Emmanuel, higher borrowing costs have changed the game for private equity houses. Between 2010 and 2021, borrowing accounted for half of all PE performance, according to the FT. Are we seeing strategy shifts in line with the movements of interest rates in this world?

Emmanuel: What we've seen is two things: First, the universe of eligible targets has somewhat shrunk a bit as bidders are looking for those targets that can sustain some decent level of leverage in the current interest rate level. The second thing is the PE managers have been focusing more on the operational performance and they've been hiring in that space rather than hiring new transactors. So that's a sign of times that are changing which is a shift from the new business and managing the portfolio and making sure that they can deliver the operational performance because that's where the outcomes should be driven.

Romil: Let's go to India, where Indian bonds are beginning their inclusion journey in emerging market indices. Confidence is quite high in India amongst investors at the moment, and the inclusion will take place over several phases. Just how big a deal is this for the world's most populous nation?

Jim: It is a big deal. We see this every time a country goes into the index – it stimulates a huge amount of buying by international bond investors, it could be tens of billions over the course of months and further out, so it'll definitely increase demand for Indian assets, show that India is part of a mature global capital market and really cement the idea that India is going to be a global powerhouse economically. We see this demographically – it's going to be overtaking China and going in the right direction in terms of population, whereas China is ageing and even shrinking in some age cohorts now. So its growth rate is strong – [but there are] lots of challenges for India, of course, moving from an agrarian economy into a manufacturing economy is going to be important for it to achieve if it wants to be the new China, but certainly it's going in the right direction. And inclusion in those bond indices is a big deal for it.

Romil: And if we zoom out of India, Fabiana, and look at equities more broadly on a global basis, equities have been all systems go. They've enjoyed an upwards momentum. What have been the driving forces behind this?

Fabiana: Look, we're just over earnings season and what we have seen are two key drivers. The first one has been beating very low expectations. This has been particularly true for European markets. The second one has been innovation – companies innovating in many different areas, not only AI but also product innovation. You're seeing many more companies, for example, in consumer staples, increasing their R&D expenditure. And that is having an impact on profitability, in particular, and we've seen earnings [expectations] being beaten quite solidly across markets.

Romil: And last year we of course saw supercharged returns from the 'Magnificent Seven' and that took the indices with them. But beyond those stocks where are you looking from an idiosyncratic point of view and coming back, as promised, how are you exercising selectivity in the current environment?

Fabiana: You know, it is very interesting. There are many investors that are convinced that [the] 'Magnificent Seven' last year, performed much better from a global standpoint compared to other stocks. In reality, in 2023, among the ten best-performing stocks in the MSCI All Country World [Index], only two, Nvidia and Meta, were in the top ten and they weren't even among the top three. This year only Nvidia is part of those top ten.

Now, the reason why I'm saying this is that these companies, even if they don't outperform the rest of the world, because of their sheer size they can take the index with them – and last year they took the S&P 500 with them. But this year, if they start just performing a little bit less solidly, they will also let the index drift a little bit. So what we're seeing this year is that there is much more broadening of the market. You find many more interesting companies and much more innovation also outside of those

'Magnificent Seven'. We are finding [these] across different countries, you just have to go global and dig deeper!

To give you an example, we found a ceramics material company in Japan that is applying AI to their, product development and right now they're really cutting those product development times. They have about 100 years of data that they're feeding in their AI machine and actually it's working out for them, so there's so much that we can find.

Romil: Fabiana, that's quite interesting because you spoke about digging deeper and going further. Investor sentiment on China has been quite negative for a while. In fact, we're seeing opportunity in China. What's behind our positive sentiment there?

Fabiana: So, Romil, we've seen opportunities in China for a long time. We've always said the Chinese market might have different drivers, but there's some very, very strong, idiosyncratic stories, companies that are competitive from a global standpoint.

Now, what you have to understand is that some companies might get caught in the policies of the government. And so you need to understand where those interests lie. At the beginning of 2024, we saw the market being oversold, we saw a stabilisation in the overall economy, we also saw some more stimulus from the government. This has brought some exuberance in the market that is seeing the market performing very well. But you know, as always happens, the tide will lift all boats and I think now we are at a time where China can still perform well, but we just need to be selective in what companies we invest in. And just to give you one extra point, Chinese companies are actually increasing their return to shareholders. We are seeing many more companies increasing both buybacks, but also dividends.

Romil: So it's really important to cut through the noise and do the research.

Fabiana: Absolutely, always.

Romil: Emmanuel, private markets. Where are you seeing compelling opportunities, particularly given the broadening appeal of private markets with the introduction of regulated frameworks such as ELTIF 2.0, which now means that a broader investor base can gain access to early-stage opportunities in areas such as private credit? Does it now feel tangible and really accessible?

Emmanuel: So, I will start with the second part of your question as to the accessibility of private markets to a broader base of investors.

I think we're solving here for three things beyond the enhancements of the regulation. The first one is the J-curve – the time it takes to ramp up. The second one is liquidity, and the third one is the diversification or, the lack of concentration. Here, what we have actually at M&G is a long history of having invested in these assets so we can solve for those three by seeding some of our existing assets and that means we can deal with those three beyond regulation. That's very helpful.

Back to the first part of your question on where the compelling opportunities are. We see three main areas. One is the energy transition – there's a vast need for funding in that segment. Tangibly, we're talking about battery storage, EV charging and the likes and there there's a very interesting opportunity for, private markets, which are well-suited to fund these new technologies with a nascent regulatory framework.

The second area is private corporate credit, where the banks do not need to take as much risk in this interest rate environment. Therefore, that leaves a gap in the riskier end of the corporate world or the mid-cap level, BB and high single B, where we think there's lots of value to be grabbed for our investors.

The third one is helping banks in Europe and in the US to optimise their return on equity and that's on the background of pretty poor returns of equity of late, as well as an increased pressure that is also putting pressure on their return on equity from the regulators with capital ratios that are going up. So, we're helping them [in] optimising their balance sheets and their exposures through regulatory capital transactions or SRT, to use the acronym of the profession.

Romil: Thank you, Emmanuel. 2024 is a record year for democracy, with billions of people taking to the voting booths around the world as they vote in national elections. Whilst it's difficult for investors – and no doubt risky – to position speculatively ahead of elections, it's quite important to be in a position to respond to what happens as opposed to predict what may happen. Fabiana, how important is the response function in portfolios?

Fabiana: Well, what kind of response function is very important? So, the actual outcome of the election doesn't determine the market journey. What determines the market journey is the policy that will follow that result. To give you some examples, some negative reactions to elections, such as in 2016 – the Brexit vote, or also the President Trump election. Whatever you think about that outcome [which] actually had an immediate negative market response but that market response turned around pretty quickly. So for active investors, that would have been an opportunity to invest in the market. And then eventually, policies determined what markets did after that.

Another data point, in India, we all know that Prime Minister Modi had some very market-friendly policies which businesses and markets, especially equity markets, really appreciated. Having said that, there are other things beside elections and policies that determine market performance, and in the case of India, the Indian equity market performed better in the ten years preceding Prime Minister Modi's election compared to the ten years following Prime Minister Modi’s election. So there are so many different inputs that determine what markets will do even after a very important election. For us right now, possibly the one election to follow more closely will be the United States election, because that will determine so many policies that will affect the rest of the world.

Romil: 5 November all eyes are on the White House and the outcome there. Jim, how about you? How do you see this momentous year for the world of bonds?

Jim: Well, the world of bonds really cares at the moment about how much governments are borrowing.

So, when we look at all the elections, people are going to be running the numbers and saying: ‘Does this mean we're going to get more and more treasuries or more and more gilts being issued? And what does that mean for prices of bonds?’ If you look at the US in particular, both candidates are fiscally expansive. Joe Biden spends money on things like the Inflation Reduction Act. Donald Trump presumably will do big tax cuts for rich people and corporations. I think that one thing bond markets are worried about is that across the world, all politicians want to give stuff away, and not many of them want to pull back the reins on government borrowing too much. That's a bit of a headwind for global bonds at the moment. Those governments that are going to spend less will probably see better bond price performance going forwards.

Romil: And Emmanuel, last but not least, you're of course looking at a much longer time horizon. So with that context, how do you see this year?

Emmanuel: We don't really look at this year in reality, because if you look at the horizon for our investors along the life of their investments they'll come across, probably, a change of government, of policy.

Therefore, yes, it's important to understand what is the debate, where is the long-term direction of travel. But when you look at the at the risk for our investors, or the opportunities, we're looking at a five, ten, fifteen year window – because it will happen, something will change.

The political world is one, but we're looking at probably the ramifications for regulatory frameworks, and that's indirect if you want, or a corollary of it. And so we need to reach across the aisle, frankly, and understand what is the debate about. Is it something that is shared across the political spectrum, or is there a specific risk in one part of the political landscape? But really, we need to take a long-term view on that, because we're likely at the receiving end of the positives or negatives of changes in policies all the time and, for us, what's more important is probably the magnitude of those changes.

Romil: Well, unfortunately that's all we have time for in today's episode. Fabiana, Jim, Emmanuel, thanks indeed for joining us here today and connecting the dots. Thank you.

Jim: Thank you.

Emmanuel: Thank you.

Fabiana: Thank you.

Romil: And thanks to you, our audience, for tuning in. We look forward to seeing you next time. Don't forget you can access a full copy of the Mid-Year Investment Perspectives 2024, in the show notes or on our website www.mandg.com/investments. Please do subscribe to our podcast and we look forward to seeing you next time, but it's goodbye for now.

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